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In the Supreme Court of the United States

OCTOBER TERM, 1989

PORTLAND GOLF CLUB, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Petitioner, a tax-exempt social club, earns gross income from the sale of food and drink to nonmembers. The variable costs of conducting this activity are less than the gross receipts, but petitioner reports a net loss from the nonmember sales because the total expenses allocated to it (both fixed and variable) always exceed the gross receipts. The question presented is whether, in determining petitioner's "unrelated business taxable income" (26 U.S.C. 511-512), these reported net losses from nonmember sales can be used to offset petitioner's unrelated investment income.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-3a) is unreported. The memorandum opinion of the Tax Court (Pet. App. 6a-42a) is unofficially reported at 55 T.C.M. (CCH) 212.

JURISDICTION

The judgment of the court of appeals (Pet. App. 4a-5a) was entered on June 1, 1989. On August 28, 1989, Justice O'Connor extended the time within which to file a petition for a writ of certiorari to and

including September 29, 1989. The petition was filed on September 28, 1989, and was granted on January 16, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 511 and 512 of the Internal Revenue Code (26 U.S.C.) are set forth in pertinent part in a statutory appendix (App., *infra*, 1a-3a).

STATEMENT

1. Petitioner is a corporation exempt from income tax as a "social club" under Section 501(c)(7) of the Internal Revenue Code,[1] which grants tax-exempt status to "[c]lubs organized for pleasure, recreation, and other nonprofitable purposes" that meet certain other requirements. Petitioner operates a private country club that has a golf course, restaurant and bar, swimming pool, and tennis courts, primarily for use by members and their guests. Nonmembers are permitted to use petitioner's restaurant and bar for banquets, receptions, and similar functions, if they are sponsored by members. Petitioner receives gross income that is unrelated to its exempt purposes—and hence subject to unrelated business income tax under Sections 511-512 of the Code—from two sources: sales of food and drink to nonmembers and interest upon its investments. Pet. App. 8a-11a.[2]

[1] Unless otherwise noted, statutory references are to the Internal Revenue Code of 1954 (26 U.S.C. (1976)), as in effect during 1980 and 1981, the tax years involved (the Code or I.R.C.).

[2] The Code imposes a tax, at regular corporate rates, on an exempt organization's "unrelated business taxable income." I.R.C. § 511. The "unrelated business taxable income" of a social club is defined by Section 512(a)(3)(A) as "the gross income (excluding any exempt function income), less the deductions allowed by this chapter [Chapter 1 of the Code] which are directly connected with the production of the gross income (excluding exempt function income)." Because the "exempt function income" is confined to membership dues and other receipts from members (see I.R.C. § 512(a)(3)(B)), all of the income that a social club receives from nonmembers, as well as interest and dividends that accrue upon its investments, is subject to unrelated business tax, whether or not the income derives from a trade or business. This treatment differs from that accorded by the Code to most other tax-exempt organizations, including charitable organizations granted exemption by Section 501(c)(3). Their "unrelated business taxable income" is defined by Section 512(a)(1) as limited to gross income from an "unrelated trade or business," reduced by "the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business." Thus, in contrast to the Code's treatment of social clubs, investment income earned by these other kinds of tax-exempt organizations is not taxable.

On its tax returns for 1980 and 1981, petitioner computed its gain or loss from the nonmember sales by deducting from gross income both "direct" or "variable" expenses (*i.e.*, those that vary with the volume of sales, such as food and beverage costs, payroll, and supplies) and also an allocable share of "indirect" or "fixed" expenses (such as taxes, depreciation, insurance, and other fixed overhead), which petitioner would have incurred to operate its facilities whether or not it served nonmembers. The allocable share of fixed expenses was deducted on the basis of petitioner's claim that those expenses were "directly connected with the production of" nonexempt income (I.R.C. § 512(a)(3)(A)); the allocation was made based on the ratio of petitioner's gross receipts from nonmember sales to its total gross receipts from sales

of food and drink to both members and nonmembers. Pet. App. 11a-13a.[3]

Petitioner's gross receipts from the nonmember sales for each year exceeded the variable expenses of that activity, but were less than the sum of the variable and allocated fixed expenses. Accordingly, petitioner reported that the nonmember food enterprise generated net losses for each year—$28,433 for 1980 and $69,608 for 1981.[4] Those losses were greater than petitioner's interest income of $11,752 for 1980 and $21,414 for 1981. Petitioner offset the losses

[3] Under Treas. Reg. § 1.512(a)-1(c), where expenses are incurred or facilities are used for both exempt and nonexempt purposes, depreciation, overhead, and similar expenses should be allocated on a reasonable basis. Expenses that are so allocated to the nonexempt activity are treated as "directly connected" to the nonexempt activity. The Commissioner did not challenge the allocation made by petitioner in this case; the parties stipulated that the allocation was reasonable. Pet. App. 12a-13a & n.5; J.A. 17.

[4] Petitioner's income tax returns did not reflect that the gross income from the nonmember sales exceeded the variable expenses. See J.A. 53, 65. In fact, the return for 1981 reported that the "cost of goods sold * * * and operations" for the nonmember sales exceeded the gross receipts. J.A. 65. But a schedule prepared by petitioner for this litigation reflected that gross receipts from nonmember sales exceeded variable costs (J.A. 85), and the Tax Court found this to be the case (Pet. App. 14a-16a, 37a n.11). According to that schedule, the net losses from nonmember sales claimed by petitioner may be reconstructed as follows:

	1980	1981
Gross income	$84,422	$106,547
Variable expenses	(61,821)	(78,407)
Allocated fixed expenses	(51,034)	(97,748)
Net loss	($28,433)	($69,608)

against the interest income, and therefore it reported no unrelated business income tax liability for 1980 or 1981. Pet. App. 21a-22a.[5]

On audit, the Commissioner determined that the losses reported by petitioner from its nonmember sales were not deductible—*i.e.*, that while the expenses allocated by petitioner to nonmember sales could be applied to reduce its income from those activities, the excess expenses could not be used to offset its unrelated investment income and shelter it from taxation. Accordingly, the Commissioner asserted tax deficiencies of $1,828 for 1980 and $3,470 for 1981 to reflect the tax due on petitioner's investment income. Pet. App. 7a; J.A. 48-51. The Commissioner reasoned that the excess expenses of a social club's nonmember activities are deductible only if petitioner carries on the nonmember sales activity with a profit motive.[6] The Commissioner found that

[5] Petitioner likewise reported net losses from nonmember sales on its tax returns for every year during the 1975-1984 period (Pet. App. 13a). As of the close of 1984, petitioner's cumulative net operating loss from nonmember sales was $418,449. J.A. 91.

[6] The general rule under the income tax law is that the expenses of a not-for-profit activity may be offset against the income from that activity, but excess expenses may not be applied against income from other sources. See 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 22.5.4, at 22-63 to 22-64 (1989); *Five Lakes Outing Club* v. *United States*, 468 F.2d 443, 446 (8th Cir. 1972) (expenses of not-for-profit activity are allowable up to, but only up to, gross income from the activity; this is "the procedure the Commissioner has long used with court approval"); cf. I.R.C. § 183. This rule reflects the Code's general determination to tax, not gross income, but net income, *i.e.*, gross income reduced by the expenses necessary to produce that income. The deduction of excess expenses (*i.e.*, those that pro-

petitioner lacked the requisite profit motive for the nonmember activity because the food and drink were priced at a level insufficient to recover the total costs allocated to that activity, so that the nonmember sales consistently yielded net losses. Pet. App. 22a-23a; J.A. 51.

2. Petitioner challenged the Commissioner's determination in the Tax Court, which ruled in its favor (Pet. App. 6a-42a). The court held that the expenses allocated to petitioner's nonmember activities could be deducted in full and therefore used to reduce its unrelated investment income. The court assumed (without deciding) that petitioner could deduct against other income its expenses from nonmember sales only if that activity was profit-motivated, but the court concluded that that standard was satisfied because petitioner intended that its gross receipts from the nonmember sales would exceed the related "direct costs" (*id.* at 35a), *i.e.*, "the cost related to those sales which would not have been incurred absent those sales" (*id.* at 37a). See *id.* at 34a-42a.

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duce losses) against income from a different source, however, does not implicate this principle; there is nothing inherently unreasonable about taxing what are genuine earnings from one source even if the taxpayer has incurred losses elsewhere. Accordingly, such excess expenses may be deducted only if specifically authorized by the Code. While the deduction of excess expenses ordinarily is authorized by the Code only when incurred in profit-motivated activity, Sections 163 and 164 of the Code are exceptions to that rule; interest and taxes may be deducted whether or not the taxpayer engaged in the activity with a profit motive. In this case, the sum of the interest and taxes claimed by petitioner as deductions connected with its nonmember sales was only $2,862 for 1980 and $3,686 for 1981 (J.A. 53, 65), and therefore those items were encompassed in the amounts that the Commissioner allowed petitioner to offset against its gross receipts from nonmember sales.

The court stated that the net losses consistently reported on petitioner's tax returns were not evidence that the sales lacked a profit motive, because those losses resulted "only by allocating a part of the expenses which petitioner would have in all events incurred" (*id.* at 37a-38a). Thus, although petitioner had allocated a portion of its fixed overhead expenses to its nonmember activity in order to generate tax losses from that activity (on the assertion that those fixed expenses were "directly connected" to the activity), the court permitted petitioner to disregard those overhead expenses in determining whether it had the requisite profit motive with respect to the nonmember activity to allow it to be able to use those losses to reduce its investment income (see *id.* at 38a-39a). The Tax Court relied heavily on its reviewed decision in *North Ridge Country Club* v. *Commissioner*, 89 T.C. 563 (1987), rev'd, 877 F.2d 750 (9th Cir. 1989), where it had ruled that it would not evaluate a club's profit motive from the standpoint of "taxable profit," but would look instead to the "incremental increase in available funds" realized by the club from the activity (89 T.C. at 572).

3. The court of appeals reversed and remanded (Pet. App. 1a-3a), on the authority of its opinion reversing the Tax Court in *North Ridge*, where the court of appeals had held that losses from nonmember activity cannot be used to offset a social club's investment income, unless the nonmember activity is conducted with a profit motive—taking into account fixed, as well as variable, expenses. In *North Ridge*, the court of appeals had expressly rejected the position taken by the Sixth Circuit in *Cleveland Athletic Club* v. *United States*, 779 F.2d 1160, 1165 (1985), to the effect that net losses from nonmember activity may be applied to reduce investment income so long

as the nonmember activity is carried on for "economic gain," *i.e.*, with the intent of collecting gross receipts in excess of variable costs. Instead, the Ninth Circuit agreed with *The Brook, Inc.* v. *Commissioner*, 799 F.2d 833, 839 (2d Cir. 1986), that "a social club must pursue a nonmember activity with a profit motive before it can properly deduct its losses under section 512(a)" (877 F.2d at 754). The court grounded that conclusion both upon the language of the statute, which limits a social club's deductions to those "allowed by this chapter," and upon the statute's legislative history, which indicates that a social club's nonexempt income should be taxed according to the same principles that apply generally to other taxpayers under the Code. In particular, the court found that Section 512(a)(3) incorporates the principles applicable to Section 162, so that expenses of the kind claimed by petitioner are deductible (in excess of gross receipts) only if the operation is conducted with a profit motive (*ibid.*).

The Ninth Circuit in *North Ridge* proceeded to hold that the profit motive test imposed as a condition to deducting excess expenses of a nonmember activity under Section 512(a)(3) is not satisfied unless a social club conducts that activity for "the production of gains in excess of all direct and indirect costs" (877 F.2d at 756). The court specifically rejected the Tax Court's view that a club's "intent to derive economic benefit from nonmember activity, before considering indirect costs," can satisfy the profit motivation requirement of the statute (*ibid.*). The court concluded that the Tax Court's interpretation of the statute would erroneously allow a portion of the club's nonexempt income to go untaxed, thus "manifestly" producing "the sort of tax-free subsidy to social club members that section 512(a) sought to prevent" (*ibid.*).

In this case, the court of appeals stated that the Tax Court had "appl[ied] the same standards we rejected in *North Ridge*," and accordingly it reversed (Pet. App. 2a). The court remanded to the Tax Court "for a determination of whether [petitioner] engaged in its non-member activities with the intent required under *North Ridge* to deduct its losses from those activities" (*id.* at 3a).[7]

SUMMARY OF ARGUMENT

A. 1. Since 1950, tax-exempt organizations have been subject to tax on certain income unrelated to their exempt purposes. The general operation of the relevant Code provisions is to classify some of the organization's income as "unrelated business taxable income," and then to tax that income in conformity with the same principles applicable to other taxpayers. In 1969, Congress enacted Section 512(a)(3) of the Code, which differentiates the tax treatment of social clubs from that of most other tax-exempt organizations. Congress determined that it was inconsistent with the rationale for the tax exemption of social clubs to allow them to use tax-exempt outside income to subsidize the recreational activities of their members. Accordingly, it provided that all income received by a social club from a nonmember source,

[7] Petitioner had argued in the Tax Court that it could have shown a net profit on its nonmember sales if it had chosen a different method of allocating the fixed costs to that activity—specifically, if it had allocated the costs according to actual use of facilities instead of gross receipts. See Pet. App. 14a-16a; J.A. 22. The purpose of the remand appears to be to allow the Tax Court to consider the argument that petitioner should be allowed to demonstrate a profit motive by using an actual use (or other) method of allocation, while continuing to use the gross receipts method of allocation in computing its taxes in order to generate tax losses that can be used to reduce its taxable income from investments.

including passive investment income, would be subject to the tax on unrelated business income. This provision deliberately expands the income tax base for social clubs as compared to most other tax-exempt organizations, which are taxed only on income produced by an unrelated "trade or business" (I.R.C. § 512(a)(1)).

The principle that tax-exempt organizations are to be taxed on their nonexempt income in essentially the same manner as other taxpayers was made fully applicable to social clubs. Thus, Section 512(a)(3) does not independently render any particular expenses deductible from a social club's taxable gross income; rather, like the parallel provision applicable to other tax-exempt organizations, it addresses the question of allowable deductions by cross-reference. A social club's nonexempt gross income may be reduced by "the deductions allowed by this chapter [Chapter 1 of the Code] which are directly connected with the production of the gross income."

2. Petitioner must demonstrate that its nonmember activity was conducted with a profit motive in order to deduct its excess expenses against unrelated investment income. For purposes of deducting expenses, the Code generally draws a distinction between activities that are undertaken for profit and those that are not. Although the gross income from any activity may be reduced by the expenses incurred to produce that income, excess expenses of an activity (which produce tax "losses") may be deducted from income derived from other sources only if the activity is intended to produce a profit. Because Section 512(a)(3) limits a social club's deductions to those "allowed by this chapter," this distinction is controlling here.

As petitioner acknowledges (Br. 10), the expenses that it seeks to deduct here are almost entirely "business expenses," such as payroll, insurance, and cost of goods sold. These expenses are rendered deductible under the Code, if at all, only by Section 162 and related provisions, which allow such deductions if incurred in a "trade or business." And it is well settled that the existence of a profit motive is essential to finding that an activity constitutes a "trade or business." Thus, in the absence of a profit motive, deductions of the kind of expenses at issue here are not "allowed by [Chapter 1]" of the Code and therefore are not allowable to petitioner.

B. The court of appeals correctly rejected petitioner's contention that its nonmember activity was profit-motivated because it was designed to produce gross receipts in excess of *variable* costs, albeit not in excess of the sum of variable costs and the fixed costs allocated as "directly connected" (§ 512(a)(3)) with that activity. The established approach for determining the existence of a profit motive is to examine the taxpayer's intent to generate gross receipts that will exceed *all* properly allocated expenses—both fixed and variable. Distinguishing between these two kinds of expenses is potentially significant in a "dual use" situation such as this one or, more typically, where a taxpayer uses property primarily for personal reasons but also to produce income. The courts have consistently held in the latter situation that it is not sufficient to establish profit motive for the taxpayer to show merely that he engages in an income-producing activity to defray the expenses of maintaining the property—such as renting a vacation home that is primarily held for personal use. The mere fact that the rental or other activity may bring in funds in excess of variable costs does not establish a profit motive that would allow the taxpayer to deduct excess expenses (whether variable or fixed) against unrelated income.

Petitioner's position also should be rejected because it rests on an inherent contradiction. The fundamental premise of petitioner's claim is that the expenses it seeks to deduct—including an allocated portion of the fixed expenses—were "directly connected" with the production of nonmember income. Petitioner should not then be permitted to reverse its field and maintain that these "directly connected" expenses are to be disregarded in the profit motive calculation. Either the allocable portion of the fixed expenses are "ordinary and necessary costs of generating" the nonmember income (Pet. Br. 33) or they are not. Moreover, the consequence of petitioner's interpretation would be to allow most social clubs, by engaging in the common practice of providing some goods and services to nonmembers, to utilize their normal overhead expenses to eliminate the tax on their investment income—thereby subverting the specific purpose for which Section 512(a)(3) was enacted.

ARGUMENT

PETITIONER'S REPORTED NET LOSSES FROM SALES OF FOOD AND DRINK TO NONMEMBERS MAY NOT BE USED TO REDUCE ITS UNRELATED INVESTMENT INCOME

In Sections 511-513 of the Code, Congress has established a comprehensive scheme governing the taxation of some of the income received by organizations that are generally tax-exempt under Section 501(c). For most of these organizations, Congress has determined that income generated by an unrelated trade or business should be taxable, but passive investment income should be tax-exempt. For social clubs like petitioner, however, Congress has determined that investment income should also be taxable, and it enacted a separate provision of the Code, Section 512(a)(3), to accomplish that goal. Petitioner here

argues for a statutory interpretation that would substantially defeat that congressional determination—by allowing social clubs pursuing their usual activities to escape taxation on their investment income.

It is a common practice for social clubs periodically to make their facilities and food services available to nonmembers for a fee, in order to raise money to defray the expenses of operating the club. Petitioner maintains that, through an allocation of its fixed operating expenses to such nonmember sales, it can treat this activity as generating tax losses that completely eliminate taxation of its investment income. If correct, this approach would allow social clubs routinely to use untaxed income from their investments to subsidize their members' recreational activities—in clear derogation of Congress's specific decision to the contrary.

But petitioner's analysis is fallacious. It is able to read Section 512 to accomplish this result only by disregarding settled rules regarding the deductibility of expenses or by manipulating the allocation of expenses to the nonmember sales in a manner that violates both traditional tax analysis and basic principles of consistency. Specifically, petitioner argues that social clubs have been granted a unique exemption from the generally applicable limitation that certain kinds of expenses are deductible only if incurred in connection with profit-motivated activity. And, alternatively, petitioner contends that it can demonstrate the existence of a profit motive by disregarding the fixed expenses allocated to its nonmember activity, while at the same time employing an allocable share of those fixed expenses to generate the tax losses that it seeks to use to shelter its investment income. Both contentions violate basic tax principles embodied in Section 512(a)(3) and would eviscerate the congressional policy underlying that provision.

A. A Social Club May Not Offset Against Its Investment Income Net Losses From Nonmember Sales Activity That Is Not Conducted With A Profit Motive

Petitioner acknowledges (Br. 10) that the expenses of its nonmember sales activity that it seeks to deduct from its investment income—such as cost of goods sold, payroll, depreciation, insurance, and similar items (see Pet. App. 11a)—are "the types of corporate expenses" whose deductibility ordinarily must be grounded in Section 162 and related provisions of the Code allowing certain deductions for "business expenses." See also Br. 21-22. Petitioner also recognizes that, under the Code in general, "a profit motive is a necessary factor in determining whether an activity is a trade or business" (Br. 23; see also *id.* at 10, 22). But petitioner disputes the logical consequence of these principles—namely, that a social club cannot deduct from investment income such "business expenses" of its nonmember activity unless that activity is profit-motivated. Instead, petitioner argues (Br. 16-35) that Section 512(a)(3) confers a unique tax benefit upon social clubs by enabling them to take deductions not allowed to other taxpayers, *i.e.*, unlimited "business expense" deductions incurred in an activity not conducted for the purpose of making a profit. This contention is antithetical to the very reason for the existence of Section 512(a)(3). That provision was designed to subject social clubs to a *greater* tax burden than other tax-exempt organizations, not to give them a special tax benefit. Petitioner's interpretation is not supported by either the language or legislative history of the provision, and it was correctly rejected by the court of appeals.

1. *Section 512(a)(3) Differentiates The Tax Treatment Of Social Clubs From Other Tax-Exempt Organizations By Making Their Passive Investment Income Taxable While Preserving The Rule That Deductions Generally Available To Other Taxpayers Under Chapter 1 Of The Code May Be Taken If Directly Connected To The Taxable Activity*

Congress first imposed the "unrelated business income tax" upon tax-exempt organizations as part of the Revenue Act of 1950, ch. 994, 64 Stat. 906, in response to the concern that some of those organizations were gaining an unfair advantage from their tax-exempt status by carrying on businesses in competition with taxpaying corporations. See generally *United States* v. *American College of Physicians*, 475 U.S. 834, 837-838 (1986); *United States* v. *American Bar Endowment*, 477 U.S. 105, 109-110 (1986). The tax is imposed, at regular corporate rates, on the "unrelated business taxable income" of organizations that otherwise qualify for tax exemption. For most categories of tax-exempt organizations (but excluding social clubs), the term "unrelated business taxable income" is generally defined by Sections 512(a)(1) and 513 to mean income from a "trade or business * * * regularly carried on" that is not substantially related to the exempt purpose of the organization, reduced by deductions "allowed by this chapter which are directly connected with the carrying on of such trade or business." Section 512(b)(1) expressly excludes dividends, interest, and other investment income from the reach of the tax. The reason for this dichotomy is that passive sources of funding are not regarded as creating unfair competition with taxpaying businesses, and hence taxation of investment income would not serve the purpose for which the tax was imposed. See S. Rep. No. 2375, 81st Cong., 2d Sess. 30-31 (1950).

Social clubs were first subjected to the unrelated business income tax in 1969, when the scope of the tax was extended to virtually all tax-exempt organizations. Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(a)(1), 83 Stat. 536. Congress determined, however, that social clubs should receive different, and somewhat less favorable, tax treatment than other tax-exempt organizations—specifically, that their investment income should also be taxed. Accordingly, Section 121(b)(1) of the 1969 Act (83 Stat. 537) added Section 512(a)(3), which provides a separate and more inclusive definition of "unrelated business taxable income" for social clubs and certain other tax-exempt membership groups.[8] Under that definition, a social club's "exempt function income," such as membership dues and other payments that it receives from members in exchange for rendering social and recreational services to them or their guests, is excluded from unrelated business income tax. The tax is imposed, however, on the remainder of the club's "gross income * * * less the deductions allowed by this chapter [Chapter 1 of the Code, §§ 1-1399] which are directly connected with the production of the gross income" (§ 512(a)(3)(A)). Thus, in contrast to most other tax-exempt organizations, social clubs are taxed on *all* income from nonmembership sources, whether or not produced by a trade or business; both income received from sales of goods and services to nonmembers and income from interest and dividends accruing upon the club's investments are subject to the tax. The deductions allowed to be taken from this expanded definition of gross income

[8] Under the present Code (26 U.S.C.), Section 512(a)(3) also applies to "voluntary employees' beneficiary associations" (§ 501(c)(9)), supplemental unemployment compensation benefit trusts (§ 501(c)(17)), and group legal services organizations (§ 501(c)(20)).

are analogous to those provided to other organizations—expenses may be deducted only if they are "directly connected" with the production of the taxable income and are otherwise allowable under Chapter 1 of the Code.

The reason for the distinction between social clubs and other tax-exempt organizations was explained in detail in the legislative history of Section 512(a)(3). Social clubs receive a tax exemption, not because they provide a public service to the community, but rather on the basis of their serving the mutual interests of their members. Congress has allowed the members of social clubs to pool their resources for their mutual benefit without having adverse tax consequences attach from the use of a corporation for that purpose. See generally B. Hopkins, *The Law of Tax-Exempt Organizations* 340-341 (5th ed. 1987). Profits generated by the provision of club services to members are used to benefit the members and therefore fall within the rationale of the tax exemption. But profits received from nonmember sources are an outside subsidy for the recreational activities of the members, and therefore the rationale for the tax exemption does not apply to such profits. Specifically, Congress determined that "all income [of social clubs] other than that derived from rendering services to the members" should be taxed because "where a social club has income from interest, dividends, rents, royalties, etc., this income reduces the members' costs below the actual cost of providing the personal facilities made available by the organization" (H.R. Rep. No. 413, 91st Cong., 1st Sess. Pt. 1, at 47 (1969)). The committee reports further commented that "the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership," and characterized extension of the exemption to investment income as "a distortion

of its purposes" (*id.* at 48; S. Rep. No. 552, 91st Cong., 1st Sess. 71 (1969)).[9]

In broadening the definition of taxable income for social clubs beyond activities that qualify as a "trade or business," Congress correspondingly broadened the deductions available to social clubs as compared with those allowable to other tax-exempt organizations. It did not, however, change the *kind* of deductions that may be taken. Section 512(a)(3) allows a social club to deduct expenses directly con-

[9] The committee reports set forth the rationale for the special treatment of social clubs in considerable detail. S. Rep. No. 552, 91st Cong., 1st Sess. 71 (1969) (see also H.R. Rep. No. 413, *supra*, Pt. 1, at 48):

> Since the tax exemption for social clubs and other groups is designed to allow individuals to join together to provide recreational or social facilities or other benefits on a mutual basis, without tax consequences, the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent his income on pleasure or recreation without the intervening separate organization. However, where the organization receives income from sources outside the membership, such as income from investments, * * * upon which no tax is paid, the membership receives a benefit not contemplated by the exemption in that untaxed dollars can be used by the organization to provide pleasure or recreation to its membership. For example, if a social club were to receive $10,000 of untaxed income from investments in securities, it could use that $10,000 to reduce the cost or increase the services it provides to its members. In such a case, the exemption is no longer simply allowing individuals to join together for recreation or pleasure without tax consequences. Rather, it is bestowing a substantial additional advantage to the members of the club by allowing tax-free dollars to be used for their personal recreational or pleasure purposes. The extension of the exemption to such investment income is, therefore, a distortion of its purpose.

nected with the production of all gross income (other than exempt function income), including expenses connected with activity that does not rise to the level of a trade or business. But Congress retained in Section 512(a)(3) the limitation that the permitted deductions are those "allowed by this chapter."[10] Thus, the deductions allowed in connection with the expanded definition of taxable income for social clubs are analogous to those provided to other tax-exempt organizations—expenses may be deducted only if they are "directly connected" with the production of the taxable income and are otherwise allowable under Chapter 1 of the Code. Neither Section 512(a)(1), for most tax-exempt organizations, nor Section 512(a)(3), for social clubs, independently renders deductible an expense that would not otherwise be deductible for other taxpayers under Chapter 1 of the Code. See generally 4 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 102.4.4, at 102-26 (1981) (social club may deduct "otherwise allowable deductions directly connected" with production of nonexempt income).[11]

[10] This phrase is used in other provisions of Chapter 1 of the Code to incorporate by reference otherwise allowable deductions. See, *e.g.*, I.R.C. §§ 172(c) (definition of net operating loss), 183(b)(1) (activities not engaged in for profit), 280A(a) (business use of home).

[11] The impetus for the enactment of Section 512(a)(3) came in part from a recommendation by the Treasury that all of a social club's receipts from investments and nonmember activity be treated as gross income subject to the unrelated business income tax, for the reasons later reiterated by Congress in its committee reports. See Staff of House Comm. on Ways and Means and Senate Finance Comm., 91st Cong., 1st Sess., *Tax Reform Studies and Proposals, United States Treasury Department*, Jt. Publication 42, 324-325 (Comm. Print 1969) [hereinafter *Treasury Proposal*]. The provision ultimately enacted by Congress tracks the recommendations of the *Treasury Proposal* with respect to both taxable income and allow-

2. *Because Section 512(a)(3) Provides No Authority For Deductions Not Permitted In Other Contexts By Chapter 1 Of The Code, Petitioner's Excess "Business Expenses" Are Not Deductible Unless They Are Incurred In Connection With Profit-Motivated Activity*

a. The deduction provisions of Chapter 1 of the Code draw a fundamental distinction between activities that are undertaken for profit and those that are not. In effect, the Code treats a taxpayer as having two personalities—"one is [as] a seeker after profit who can deduct the expenses incurred in that search; the other is [as] a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption and related expenditures." *United States* v. *Gilmore*, 372 U.S. 39, 44 (1963) (brackets in original) (quoting S. Surrey & W. Warren, *Cases on Federal Income Taxation* 272 (1960)). The Code specifically enumerates a few expenses—such as interest, taxes, and casualty losses—that can be deducted in computing taxable income even if they do not relate to profit-seeking endeavor. See I.R.C. §§ 163, 164, 165(c). Apart from specific exceptions, however, excess expenses of a not-for-profit activity cannot be applied to offset taxable income from other sources. See generally 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶¶ 20.1.1, 22.5.4 (1989); note 6, *supra*.

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able deductions. The *Treasury Proposal* explained (at 324-325) that deductions should be allowed only for expenses "directly connected with an activity generating income subject to tax" and indicated that the expenses would have to be "otherwise deductible" under the Code. The phrase "allowed by this chapter" embodies in Section 512(a)(3) the recommendation of the *Treasury Proposal* that expenses must be "otherwise deductible" in order to be deducted by a social club; Section 512(a)(3) does not independently allow deductions for any particular kind of expenses.

Among the most important of the provisions of Chapter 1 to which a profit-motive limitation applies is Section 162, which grants a deduction for "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The indicia of a "trade or business" for purposes of Section 162 include the regularity, continuity, and extensiveness of a taxpayer's commercial activities. See, *e.g.*, *McDowell* v. *Ribicoff*, 292 F.2d 174, 178 (3d Cir.), cert. denied, 368 U.S. 919 (1961). But "[i]t is well established that the existence of a genuine profit motive is the most important criterion for the finding that a given course of activity constitutes a trade or business." *Lamont* v. *Commissioner*, 339 F.2d 377, 380 (2d Cir. 1964) (citing cases); see also *Independent Elec. Supply, Inc.* v. *Commissioner*, 781 F.2d 724, 726 (9th Cir. 1986) (existence of profit motive is "primary inquiry"). Noting the "voluminous jurisprudence" to that effect, this Court has recognized that "[t]he standard test for the existence of a trade or business for purposes of § 162 is whether the activity 'was entered into with the dominant hope and intent of realizing a profit.'" *United States* v. *American Bar Endowment*, 477 U.S. at 110 n.1 (quoting *Brannen* v. *Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984)). Accord, *Commissioner* v. *Groetzinger*, 480 U.S. 23, 35 (1987) ("the taxpayer's primary purpose for engaging in the activity must be for income or profit" if it is to qualify as a trade or business); see also Pet. Br. 23.[12]

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[12] Section 212, which grants individuals a deduction for expenses sustained for "the production of income," albeit not in an activity that rises to the level of a trade or business, likewise contains a profit-motive test. This Court explained in *United States* v. *Gilmore*, 372 U.S. at 46, that "the only kind of expenses deductible under [the predecessor of Section 212] are those that relate to a 'business,' that is, profit-seeking,

b. Petitioner acknowledges (Br. 10) that the expenses it treated as "directly connected" with its sales of food and drink consist almost entirely of the kind of expenses rendered deductible, if at all, by Section 162 and related provisions of the Code—*i.e.*, they are "business" expenses, such as payroll, depreciation, insurance, and cost of goods sold. See Pet. App. 11a. Under the established rules of Chapter 1, excess expenses of that kind may not be deducted from other income of the taxpayer unless they are sustained in an activity that is intended to make a profit. Section 512(a)(3) expressly incorporates the rules generally governing deductions permitted by Chapter 1, and therefore petitioner may not use excess expenses from its nonmember sales to reduce its taxable investment income, unless it engaged in that sales activity with a profit motive. No provision of the Code—neither Section 512(a)(3) nor anything elsewhere in Chapter 1—authorizes the deduction of excess "business" expenses incurred in an activity not motivated for profit.

Moreover, if this profit-motive limitation were not retained in Section 512(a)(3), the statute would not achieve its basic goal of putting the members of a social club on an equal footing with other taxpayers with respect to the club's income from sources outside the membership, specifically including income from investments. The underlying policy reason for the enactment of Section 512(a)(3) would also be defeated. If a social club could eliminate taxation of its investment income by means of a deduction that would be denied to other taxpayers—*i.e.*, a deduction

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purpose." See also *Snyder* v. *United States*, 674 F.2d 1359, 1364 (10th Cir. 1982). Section 167(a) limits depreciation deductions to property that is "used in the trade or business" or that is "held for the production of income." See, *e.g.*, *Duffy* v. *United States*, 690 F.2d 889, 901-902 (Ct. Cl. 1982).

of excess "business" expenses incurred in a not-for-profit activity—it could thereby use tax-exempt investment income to subsidize the recreational activities of the members. That is precisely the result Congress sought to avoid by enacting Section 512(a)(3) because it recognized that this would give the members of social clubs an unfair tax "advantage" over other taxpayers who, "without the intervening separate organization," must spend after-tax earnings on recreational pursuits. See H.R. Rep. No. 413, *supra*, at 48; S. Rep. No. 552, *supra*, at 71. Thus, both the language and the purpose of Section 512(a)(3) require that social clubs be subject to the same profit motive limitations that govern deductions generally made available to other taxpayers in Chapter 1 of the Code.

The courts of appeals that have construed Section 512(a)(3), with the exception of the Sixth Circuit in *Cleveland Athletic Club, Inc.* v. *United States*, 779 F.2d 1160 (1985) (see note 15, *infra*), have recognized that it should not be read to eliminate the profit motive limitation on the deductibility of "business" expenses. In *North Ridge Country Club* v. *Commissioner*, 877 F.2d 750, 754 (1989), the Ninth Circuit concluded that it would be "at odds with the language of section 512(a)(3)(A) to permit the Club to deduct losses from nonmember activities without grounding the deduction on a provision of Chapter 1 of the Code." The court explained that the only provision of Chapter 1 that could authorize deduction of the losses claimed by the club in that case—losses indistinguishable from those claimed by petitioner here—was Section 162, "which requires a profit motive." *Ibid.* And the court also observed that an interpretation that failed to retain the profit motive requirement would contravene the very purpose for enact-

ment of Section 512(a)(3) because it would confer an unwarranted tax benefit upon social clubs (*ibid.*):

> Congress sought to eliminate the differences between the tax treatment afforded individuals seeking independent recreation, and the treatment given to those seeking recreation through a social club. It is contrary to this purpose to read section 512(a) to allow social clubs to deduct losses in activities not entered into for profit, while denying individuals the same deduction.

In *The Brook, Inc.* v. *Commissioner*, 788 F.2d 833 (1986), the Second Circuit also concluded that the language and underlying policy of Section 512(a)(3) preclude a social club from reducing its investment income by the net losses generated by nonmember activity not conducted for profit. Construing the "plain language and legislative history of § 512(a)(3)(A)," the court held that a social club is "required to establish that § 162 of Chapter 1, which is incorporated by reference in § 512(a)(3)(A), authorizes its deduction from its investment income of the losses suffered from its serving of meals to non-members." 799 F.2d at 838. That requirement, the court continued, means that the expenses may be deducted "only if the taxpayer engaged in the activity with the intention of making a profit" (*ibid.*). The court further observed that the contrary interpretation "would negate Congress' express purpose that social clubs be treated neutrally with respect to their unrelated business income and neither suffer nor benefit under the Code" (*ibid.*). If Section 512(a)(3) did not include the profit motive limitation on the deductibility of "business expenses," it would grant social clubs a special tax advantage "by allowing them to take § 162 deductions unavailable to other taxpayers, *i.e.*, for expenses incurred in activities not engaged in for a profit" (799 F.2d at 839). Accordingly, the court below was entirely correct in reaffirming its prior holding in *North Ridge* that "a social club must pursue a nonmember activity with a profit motive before it can properly deduct its losses under section 512(a)" (877 F.2d at 754).

3. *Petitioner Misreads The Statute In Contending That Section 512(a)(3) Creates A Special Rule For Social Clubs That Eliminates The Profit Motive Requirement For The Deduction Of Excess "Business Expenses"*

Petitioner has not questioned that the interpretation of Section 512(a)(3) by the court below best effectuates the policy concern that led Congress to enact the provision—namely, to prevent social clubs from using tax-free investment income to subsidize their members' recreational activities. Indeed, petitioner does not appear to take issue with the Ninth Circuit's obervation in *North Ridge* that the interpretation of the statute proffered by the taxpayer in that case (indistinguishable from petitioner's) would yield "the sort of tax-free subsidy to social club members that section 512(a) sought to prevent" (877 F.2d at 756). Moreover, petitioner concedes that, under the terms of Section 512(a)(3), deductible "expenses must be of a kind which is allowed as a deduction *to a business* under Chapter 1 of the Code" (Pet. Br. 21-22 (emphasis added)), and it recognizes (*id.* at 10, 22-23) that, apart from social clubs, no taxpayer, including a tax-exempt organization governed by Section 512(a)(1) (Br. 19), is permitted to deduct excess expenses of this sort unless they are incurred in a profit-motivated activity. Petitioner's principal contention therefore (Pet. 16-35) is that, regardless of the policies underlying Section 512, the text of the statute (read literally but not "too literally" (see Pet. Br. 27, 28)) necessarily creates a unique tax benefit for social clubs—one that permits them to deduct (against unrelated investment in-

come) excess "business expenses" incurred in an activity not motivated by profit. This contention simply misinterprets the language of Section 512(a)(3); nothing in that provision, which was enacted to subject social clubs to a *greater* tax burden than other tax-exempt organizations, has the effect of conferring upon social clubs a special tax benefit not available to other taxpayers.

a. Petitioner's primary contention (Br. 16-26) is that, because Section 512(a)(3) taxes income that is derived from activity not rising to the level of a trade or business and allows associated deductions, the provision necessarily eliminates any requirement that "business" expenses actually be incurred in connection with a business, *i.e.*, a profit-motivated activity. Petitioner buttresses this contention by arguing that, because all of this nonexempt income has been classified as "unrelated business taxable income" for purposes of levying the tax, all nonexempt activities of social clubs "are by definition unrelated *business* activities" (Br. 22). "Where Congress has defined an activity as a 'business,'" petitioner continues, "there is no need to test the activity further for profit motivation" (Br. 23). Petitioner also ascribes great significance to the absence from Section 512(a)(3) of the phrase "trade or business" (Br. 23-26).

Petitioner's analysis suffers from two major flaws: First, it ignores the historical context of Section 512(a)(3) and the logical reasons why the language upon which petitioner relies was chosen; second, it disregards—indeed, nullifies—the one phrase in Section 512(a)(3) that is specifically addressed to the question of what expenses are deductible—*viz.*, "the deductions allowed by this chapter."

As we have noted (p. 15, *supra*), Congress first determined in 1950 to tax some of the income of certain tax-exempt entities. At that time, the only kind

of income taxed was income derived from a "trade or business" unrelated to the organization's exempt purposes, and that income was referred to in the statute as "unrelated business taxable income." When Congress determined in 1969 that social clubs should be taxed on a broader class of income, including investment income, it accomplished that goal within the existing statutory framework of Sections 511-513 by providing that such income "would be treated and taxed as business income" (H.R. Rep. No. 413, *supra*, at 47). The statute continues to use the term "unrelated business taxable income" to describe the taxable income of social clubs simply because that was the term historically used with respect to other tax-exempt organizations to identify the base on which the unrelated business income tax was imposed. Congress manifestly did not intend that nonbusiness activity—such as management of investments or activity not motivated by profit—would be transformed by Section 512(a)(3) into a "trade or business" for all purposes.

Similarly, the differences in language between the definitions of taxable income for social clubs (§ 512(a)(3)) and for other tax-exempt organizations (§ 512(a)(1)) do not operate to eliminate for social clubs the profit motive requirement for the deduction of "business expenses." Prior to 1969, only income derived from a "trade or business" was subject to the unrelated business income tax. It logically followed that the only allowable expense deductions should be for those "connected with the carrying on of such trade or business," as Section 512(a)(1) provided. The motivation for enacting Section 512(a)(3) was to expand for social clubs the kinds of income that would be subject to taxation; once the source of taxable income was no longer restricted to that derived from a "trade or business," Congress naturally also

removed the restriction that deductions be connected to a "trade or business." But while this change allowed social clubs to deduct from their nonbusiness income expenses that the Code generally allows other taxpayers to deduct from such income (*e.g.*, certain taxes and interest), it plainly was not designed to give social clubs the right to deduct excess "business" expenses connected with nonbusiness (*i.e.*, not-for-profit) activity.[13] As the Second Circuit stated in *The Brook*, 799 F.2d at 841, "it may not * * * be inferred from the difference in language between § 512(a)(1) and § 512(a)(3) that Congress intended social clubs to be relieved from the requirements of § 162 so that they would receive an advantage over other taxpayers claiming deductions under that provision." Rather, "the difference is rooted in Congress' intent to tax entities such as social clubs more comprehensively than charitable and religious organizations, which are dedicated to more altruistic purposes." *Id.* at 840; see also *North Ridge*, 877 F.2d at 753-754.[14]

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[13] The legislative history cited by petitioner (Br. 20-21) adds nothing to its argument based on the statutory language. The language quoted from the House Report and from the *Treasury Proposal* merely helps to confirm what is undisputed —namely, that Congress sought to expand the definition of taxable income for social clubs to include income from activities that do not rise to the level of a "trade or business," and to allow the deduction of expenses directly connected with those nonbusiness activities, so long as the expense is "otherwise deductible" (*Treasury Proposal* at 325), *i.e.*, allowed by Chapter 1 of the Code. As the Ninth Circuit noted in *North Ridge*, the Treasury's explanation "clearly does not say that deduction of *losses* is proper even if the non-member activity was not entered into for profit" (877 F.2d at 755).

[14] Petitioner's argument that it is "unfair" to tax a social club on its nonbusiness income, and then confine its deductions to trade or business deductions (see Pet. Br. 27), is misconceived. The deductions allowed by Section 512(a)(3) are properly tailored to the income subjected to tax. See *The Brook*, 799 F.2d at 841. Petitioner is permitted the full range of deductions, business and nonbusiness, that are authorized by the Code and connected with the production of its nonexempt income. The expenses whose deductibility is in question here, however—namely, the allocable expenses of petitioner's nonmember sales in excess of gross receipts—are of the kind allowed, if at all, only by Section 162. They accordingly must meet the requirements of that provision, which means that they must be incurred in a profit-motivated activity, in order to be allowable under Section 512(a)(3).

Moreover, by expressly limiting deductions under Section 512(a)(3) to those "allowed by this chapter," Congress ensured that social clubs could not take deductions against their nonexempt income that would be unavailable to other taxpayers—including deductions for "business expenses" not incurred in a profit-motivated activity. Although petitioner has conceded that the requirement that deductions be "allowed by this chapter" is one "prong" of a "two prong" test under Section 512(a)(3) (see Pet. Br. 21-22), petitioner's theory would effectively nullify that requirement. Under petitioner's reading of the statute, *every* ordinary and necessary expense connected with the production of a social club's nonexempt income would automatically be converted into a deductible business expense that satisfies the "allowed by this chapter" limitation, irrespective of whether the expense would qualify for deduction under Section 162 or another provision of Chapter 1. A test that is always satisfied is no test at all. Furthermore, petitioner's interpretation would violate what it concedes is one of the basic commands of Section 512(a)(3)—that a social club's nonexempt activities "are subject to tax in the same manner as any taxable business is taxed" (Pet. Br. 20). In sum, both the statutory text and its underlying policy

are inconsistent with petitioner's contention that Section 512(a)(3) excuses social clubs from the general rule that "business expenses" may be deducted only if incurred in connection with a profit-motivated activity.[15]

b. Petitioner contends (Br. 29-32) that Section 512(a)(3) contemplates that a social club should "aggregate" its expenses, instead of breaking them down on an activity-by-activity basis, and therefore that net losses from its nonmember sales automatically reduce its investment income, without the need for any inquiry into profit motive. Otherwise, petitioner maintains, social clubs would be disadvantaged in comparison with nonexempt taxpayers who allegedly "are allowed to deduct net losses from one business activity against net income from a different business activity" (Br. 30). As an example, petitioner invokes the case of a gambling establishment that consistently incurs losses from serving food and drink to patrons of the casino: the business would not be prevented from offsetting those losses against its casino income. This argument is misconceived.

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[15] Significantly, even petitioner recognizes (Br. 27-29) that some kind of profit motive requirement—that receipts exceed variable costs (which it terms "economic gain")—must be embodied in Section 512(a)(3) in order to avoid eviscerating the statutory purpose. Accordingly, petitioner cautions against reading the statute "too literally" (Br. 27, 28), embracing the Sixth Circuit's holding in *Cleveland Athletic Club* v. *Commissioner*, *supra*, that all expenses incurred in an activity intended to produce this kind of "economic gain" are deductible under Section 512(a)(3). See 779 F.2d at 1165. In our view, the imposition of this "economic gain" requirement (or defining "profit" under Section 162 in terms of "economic gain," which leads to the same result (see point B, *infra*)) does not prevent petitioner's interpretation from doing violence to the congressional intent. In any event, petitioner's theory is not consistent with the statutory text.

Contrary to petitioner's contention, the decision of the court of appeals does tax social clubs on their nonexempt income according to the same rules that apply to other taxpayers. The reason that a gambling casino is able to deduct excess expenses of its food and bar service is because of the close business connection with its gambling operations; the food service is designed to facilitate the production of income from the gambling operation. In short, the two activities should not be viewed separately; they are part and parcel of the same business. By contrast, there is no connection between petitioner's meal service and the production of the interest income that accrues upon its investments. Where there exists a sufficient nexus, losses from one component of an activity appropriately can be netted against gains from another component of the same activity without examining each separately for profit-motivation. Cf. Treas. Reg. § 1.183-1(d)(1) (operations bearing sufficient "economic interrelationships" comprise one "activity" for purposes of combining gains and losses); 1 B. Bittker & L. Lokken, *supra*, at ¶ 22.5.3. Because petitioner's sale of food and drink to nonmembers constitutes an entirely separate activity from its receipt of income from a savings account, this kind of netting to enable petitioner to shelter its investment income is improper.

More generally, neither the statute (see Pet. Br. 25 & n.15) nor the Commissioner's proposed regulation concerning social clubs (see Pet. Br. 30-32) supports petitioner's contention that expenses are to be aggregated in a way that does not require consideration of profit motive. Prop. Treas. Reg. § 1.512(a)-3(b), 36 Fed. Reg. 8806 (1971) (which petitioner concedes had no force or effect (see Pet. Br. 32 n.23) and has been withdrawn), stated that the unrelated business taxable income of a social club

deriving income from more than one source "is computed by aggregating its gross income from all such sources and by aggregating its deductions *allowed* with respect to such gross income" (Prop. Treas. Reg. § 1.512(a)-3(b)(3) (emphasis added)). Because the proposed regulation addressed the aggregation only of deductions that are "allowed," it did not suggest that petitioner could mingle losses from its nonmember sales activity together with income from its investments, if the sales activity were not engaged in with a profit motive. In accordance with the text of the statute, the word "allowed" in the proposed regulation must be read in the context of the regulation's general statement that, "to be deductible in computing unrelated business taxable income [under Section 512(a)(3)], expenses, depreciation, and similar items * * * must qualify as deductions under chapter 1 of the Code" (Prop. Treas. Reg. § 1.512(a)-3(b)(1)). See also Prop. Treas. Reg. § 1.512(a)-3(b)(2) (expense must be "otherwise allowable under chapter 1 of the Code"). Unless petitioner's nonmember sales activity is carried on with an intent to make a profit, the expenses allocated to that activity are "allowed" only to the extent of offsetting the income that it produces; no excess expenses are "allowed" to be deducted and hence there is no available loss that can even enter into the aggregation process. See *The Brook*, 799 F.2d at 838 (social club is entitled to "aggregate deductions * * * as permitted by § 162 to other taxpayers"); *North Ridge*, 89 T.C. at 571-572 (social club's income production must be broken down on activity-by-activity basis so that profit motive for each activity can be determined).[16]

[16] There is similarly no merit to petitioner's assertion (Br. 26 & n.16) that the computation of a social club's unrelated business taxable income from nonmember sales activity "becomes impracticable" if a profit motive test is imposed on the allowance of deductions. The computation of the taxable income from nonmember sales is essentially a two-step process. First, the club computes the expenses "directly connected with" the production of income from the sales; this may require an allocation of fixed expenses, which in this case was made using a gross receipts method. Second, the expenses must be examined to determine whether their deduction (in excess of the gross income from the sales) is "allowed by this chapter." This determination requires resolving whether the sales activity is motivated by profit. This two-step procedure is eminently practicable as a matter of computation; indeed, this procedure is required to implement the "two prong test" that petitioner concedes to be established by Section 512(a)(3) (see Pet. Br. 21-22).

Finally, petitioner argues (Br. 33) that it is irrational to prevent it from deducting, even for the purpose of sheltering investment income, all of the expenses that it allocates to its nonmember sales because those expenses "are the ordinary and necessary costs of generating the economic gains which were provided by the unrelated business activities." This description obscures the true effect of petitioner's claimed deduction and the extent to which it subverts the statutory purpose. The Commissioner *does* allow petitioner to offset the ordinary and necessary costs of generating "economic gains" against its nonmember sales receipts. So long as the gross receipts do not exceed the costs of that activity, the Commissioner would not require petitioner to recognize any net income from the activity and would not collect any tax upon it. But petitioner is not satisfied with this tax treatment. Petitioner seeks to use the allocated fixed costs not simply to offset its income from the activity, but rather to generate "tax losses," which it can then use to offset its unrelated investment income. A deduction of that sort must be authorized by Section 162, which means that the ac-

tivity generating the losses must be conducted with a profit motive.

B. An Activity Is Not Motivated By Profit When It Is Not Intended That The Gross Receipts From That Activity Will Exceed The Expenses Properly Allocable To It, Both Fixed And Variable

Petitioner's secondary argument (Br. 35-48) is that, even if a profit motive is required for it to deduct the excess expenses of its nonmember sales, it has demonstrated such a profit motive because it intended the nonmember activity to produce "economic gain"—defined as gross receipts in excess of variable costs of the activity. In other words, petitioner argues that, even though it has allocated a portion of the fixed expenses to its nonmember sales in order to generate steady losses (totalling more than $400,000 for the years 1974-1984 (J.A. 91)), those expenses can be completely disregarded in testing the nonmember sales activity for the profit motive necessary to establish deductibility because the fixed expenses would be incurred even if there were no nonmember sales activity.

The court of appeals correctly rejected this contention. The established approach for determining profit motivation in resolving whether an activity is a "trade or business" is to compare gross receipts with *all* properly allocated expenses, fixed as well as variable. There is no support for petitioner's assertion that the profit motive inquiry should exclude one segment of the economic costs of producing income—the allocable portion of fixed costs.

Indeed, petitioner's argument rests on an inherent contradiction. The net losses reported from the nonmember sales that petitioner seeks to offset against its investment income result from petitioner's allocation of a portion of the fixed expenses as "directly connected" to that nonmember activity (I.R.C.

§ 512(a)(3)). If these expenses are directly connected to the production of nonmember income, there is no logical justification for excluding them from the cost calculation when trying to determine whether that activity is profit-motivated. Finally, allowing petitioner to manipulate the fixed expense allocation in this manner would eviscerate the effectiveness of the statute. Petitioner's argument would make it relatively easy for any social club to allocate fixed expenses to nonmember activity so as to generate net losses from that activity that could then be used to eliminate the tax on the club's investment income.

1. Petitioner's interpretation of profit motive finds no support in other contexts. The standard approach for deciding whether an activity is conducted with the profit motivation required to constitute a "trade or business" is to measure gross receipts against *all* of the expenses of the activity, drawing no distinction based on whether the expenses are fixed or variable. On many occasions, the courts of appeals have identified "profit" for these purposes with "taxable income," which necessarily contemplates reduction of gross income by both fixed and variable expenses. In *Hirsch* v. *Commissioner*, 315 F.2d 731, 736 (1963), the Ninth Circuit observed that the primary inquiry when determining whether a particular activity constitutes a trade or business under Section 162 is whether it was "entered into, in good faith, with the dominant hope and intent of realizing a profit, i.e., taxable income, therefrom." Accord, *Independent Elec. Supply, Inc.* v. *Commissioner*, 781 F.2d at 726; *Bessenyey* v. *Commissioner*, 379 F.2d 252, 256 n.5 (2d Cir.), cert. denied, 389 U.S. 931 (1967); *Weir* v. *Commissioner*, 109 F.2d 996, 998 (3d Cir.), cert. denied, 310 U.S. 637 (1940). Similarly, in *Miller* v. *Commissioner*, 836 F.2d 1274, 1278-1279 (1988),

the Tenth Circuit reasoned that the phrase "transaction entered into for profit" in Section 165(c) of the Code connotes "an ultimate objective of producing taxable income." And numerous decisions construe the business deduction provisions of the Code to disallow, for failure to satisfy the profit motive requirement, losses from activities that produce some gross income, but not enough to recoup all the related expenses. See *The Brook*, 799 F.2d at 838-840 (collecting cases).

The salient feature of this case is that, according to petitioner's reported allocation, the fixed expenses are incurred in connection with two very different purposes—primarily in connection with the exempt purpose of furthering the social and recreational interests of the club's members, and partially in connection with the nonmember sales. The primary reason for the nonmember sales activity is to produce a positive "cash flow" (an excess of gross receipts over the extra expenses occasioned by the sales) that will help to defray some of the fixed costs that are being incurred anyway. See Pet. Br. 38-39, 46-47. This situation is closely analogous to the relatively common "dual use" situation where fixed overhead may be regarded as being expended both for personal reasons and for income production. There are many cases where a taxpayer owns property (such as a farm, yacht, or vacation home) primarily for personal reasons, but in order to defray the expenses of its maintenance, he also puts the property to use in an income-producing activity. In these "dual use" or "hobby" cases, the secondary activity will help defray expenses by bringing in gross income that exceeds the variable costs of conducting that activity; typically, however, the income will not be sufficient to cover the sum of the variable expenses and an allocable portion of the fixed expenses that might be reported as directly connected

with the income-producing activity. In such a situation, an individual may offset the expenses of the secondary activity against the income it produces, but he may not deduct any excess expenses if the activity is "not engaged in for profit." See I.R.C. § 183(a) and (c).

There is no authority suggesting that the portion of the fixed expenses allocated to the income-producing activity may be ignored in determining whether the activity is engaged in with an intent to make a profit, on the ground that those expenses would have been incurred by the taxpayer anyway in the absence of the income-producing activity. To the contrary, because the tax law draws a fundamental distinction generally allowing deduction of business expenses while precluding deduction of personal expenses, the nonbusiness origin of those allocated fixed expenses strongly suggests that they must be taken into account in making a profit motive determination that will decide their deductibility. For example, in *Carkhuff* v. *Commissioner*, 425 F.2d 1400 (6th Cir. 1970), the court rejected the taxpayers' attempt to offset against other income losses generated by depreciation deductions on a vacation home that was rented for part of the year. The court acknowledged that the purpose of renting could have been to "minimiz[e] the cost of maintaining a resort home" (*id.* at 1405), but it held that this desire to produce a positive cash flow did not demonstrate a "profit motive". See also *Carter* v. *Commissioner*, 645 F.2d 784, 789 (9th Cir. 1981) (although taxpayers chartered yacht in an "attempt[] to recoup some of their costs," that does not constitute profit motive); *Antonides* v. *Commissioner*, 893 F.2d 656, 660 (4th Cir. 1990), aff'g 91 T.C. 686, 697 (1988); *Martin* v. *Commissioner*, 50 T.C. 341, 364 (1968) (same); cf. also I.R.C. § 280A (limiting deduction of

expenses connected with rental of vacation home). Thus, a mere intent to produce gross receipts in excess of variable costs is insufficient to establish a "profit motive." If the rule were otherwise, there would be a large loophole in the Code enabling individuals to use what are primarily personal expenses to shelter taxable income.[17]

Accepting petitioner's interpretation of profit motive in this context would open the same kind of loophole in the taxation scheme for social clubs. Petitioner has received income from its investments that is presumptively subject to taxation. Petitioner then engages in another activity, sales of food and drink to nonmembers, that assertedly is designed to defray the costs of operating the club. Although this activity brings additional funds into the club's coffers (see Pet. Br. 47), petitioner maintains that the tax effect of this additional infusion of funds is to *eliminate* any tax on the investment income. This is accomplished by deducting against the investment income

[17] For example, suppose an individual, who still receives substantial income from an annuity, retires to live on a large farm where he raises horses for pleasure. Though he undisputedly does not raise the horses to make a profit, he does engage in one activity to defray some of the expenses of the operation. On several occasions during the year, the taxpayer allows schools and summer camps to bring their students to visit the farm and pet the horses. The taxpayer charges the organizations a fee for the right to visit. Although the fee is relatively modest, it exceeds the minimal variable costs of the activity, which consist of hiring one college student per visit to keep an eye on the group. Under petitioner's interpretation of profit motive as "economic gain," the taxpayer in this example could claim that he operates his "horse petting" activity with a profit motive and then could reduce his annuity income by an allocable share of the substantial costs of raising the horses.

fixed overhead expenses that petitioner acknowledges are incurred in order to further the club's recreational activities, and would be incurred irrespective of the club's nonmember activity. Section 512(a)(3) does not permit this untoward result because "profit motive" means an intent that an activity produce an excess of gross income over all the expenses properly allocated to the activity. To the extent that an allocable portion of petitioner's fixed expenses is "directly connected" to its nonmember activity so as to warrant offset against the gross income generated by that activity, those expenses must also be considered in determining whether that activity was engaged in with the requisite profit motive. See *North Ridge*, 877 F.2d at 754; *The Brook*, 799 F.2d at 839 ("The mere fact that hobbies generate receipts, or 'economic gain', does not entitle them to § 162 tax treatment.").[18]

[18] Indeed, even the Sixth Circuit's decision in *Cleveland Athletic Club* appears to recognize that petitioner errs in generally interpreting "profit motive" to mean an excess of gross receipts over variable costs. The court there stated that "the challenged deductions need not necessarily come within the § 162 trade or business allowance, but rather, the deductions are allowable as ordinary and necessary to the production of income with a basic purpose of economic gain" (779 F.2d at 1165). Thus, the court did not rule for the taxpayer because it thought that an intent to produce "economic gain" satisfies the profit motive standard of Section 162; instead, it held that, because Section 512(a)(3) does not contain the phrase "trade or business," there is a special rule for social clubs that permits them to deduct expenses incurred with the intent of producing income in excess of variable costs. See 779 F.2d at 1165. As we have explained (pp. 27-30, *supra*), the Sixth Circuit misinterpreted Section 512(a)(3) in this regard because omission of the phrase "trade or business" was integral to accomplishing the purpose for which the provision was enacted; it was not designed to, nor does it in effect, allow a social club to take a deduction not otherwise allowable to

2. Petitioner errs in asserting (Br. 39-42) that its position is supported by a line of cases stating that the "profit motive" inquiry should be based on the intent to earn an "economic profit." Despite the superficial similarity between the language used in those cases, which almost all concern tax shelters, and the term "economic gain" that petitioner uses here, the concepts are quite different. It is, to be sure, well established that a taxpayer's profit motive must be demonstrated in terms of "economic profit"—in the sense that accompanying tax benefits are not relevant. Thus, in the tax shelter context, where a motive to achieve "economic profit" must be shown in order to offset a loss against other income, the taxpayer must have intended his investment to yield profits apart from the tax benefits generated by the shelter itself (in the form of claimed deductions for economic losses).[19] But those cases do not suggest that fixed expenses are to be disregarded in determining whether

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other taxpayers under the Code. The Tax Court in *North Ridge*, on the other hand, did accept petitioner's position that profit motive is to be determined by comparing gross receipts with variable costs. 89 T.C. at 572-573. The court cited no authority and did not elaborate on its conclusion.

[19] See, *e.g.*, *Simon* v. *Commissioner*, 830 F.2d 499, 500 (3d Cir. 1987) ("'profit' means economic profit independent of tax savings"); *Gefen* v. *Commissioner*, 87 T.C. 1471, 1490 (1986) ("A transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits."); *Waddell* v. *Commissioner*, 86 T.C. 848, 894 (1986) ("taxpayers were just buying tax deductions, not entering into economically motivated investments"); *Estate of Baron* v. *Commissioner*, 83 T.C. 542, 560 (1984) (inquiry into "economic consequences of the transaction aside from its tax benefits"); Treas. Reg. § 1.512(a)-1(f)(7)(ii)(b) (activity "will result in economic profit (without regard to tax consequences)").

an activity is conducted for "economic profit." Indeed, those cases do not even arise in a "dual use" situation, which is essentially the only context in which the distinction petitioner seeks to draw between fixed and variable expenses would be significant for tax cases. Thus, the authority relied upon by petitioners has no bearing on the question presented here.[20]

Petitioner erroneously contends (Br. 43-46) that the court of appeals' interpretation of "profit motive" is inconsistent with the fact that many business corporations report large losses on their tax returns while realizing substantial book profits. But, in contrast to this case, such losses do not reflect the economic costs of the activity in question, but rather the operation of various tax preferences specifically provided by Congress in the Code. The corporate losses cited by petitioner result from accelerated depreciation, investment tax credits, and other tax pref-

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[20] By the same token, the IRS's ruling addressing this issue, Rev. Rul. 81-69, 1981-1 C.B. 351, in referring to the "cost of sales" does not distinguish between fixed and variable costs. Cf. Pet. Br. 42. Quite apart from the fact that the Commissioner is the best judge of the meaning of his own rulings and regulations (see, *e.g.*, *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 484 n.19 (1979)), there is no basis for failing to read the ruling as stating that a deduction must be denied where a social club does not intend its gross income from nonmember sales to exceed *all* the costs of those sales. Every court that has considered the ruling has so construed it. See *The Brook*, 799 F.2d at 835-836 & n.4; *Cleveland Athletic Club*, 779 F.2d at 1165-1166. Rather than looking to the dictionary to define "cost of sales" (see Pet. Br. 42 n.45), petitioner should look to its own representations on which its claim for deduction rests—namely, that the allocated fixed costs here were the "ordinary and necessary costs" of producing the nonmember sales income (*id.* at 33).

erences and incentives. See Citizens for Tax Justice, *130 Reasons Why We Need Tax Reform* 8-10 (July 1986). The policy underlying such tax incentives is to stimulate investment and business enterprise by enabling a taxpayer to report a smaller profit (or larger loss) in a given year than it actually experiences in economic terms; indeed, petitioner recognizes that such deductions used by corporations to generate tax losses do not "accurately measure net income" (see Pet. Br. 44 n.47). For example, accelerated depreciation may allow the cost of property to be recovered, in the initial years after the property is placed in service, faster than the property in fact wears out or becomes obsolete, thus permitting a taxpayer to show a tax loss in a year in which an investment produces "a positive cash flow" or is "economically profitable." S. Rep. No. 552, *supra*, at 212; see H.R. Rep. No. 658, 94th Cong., 2d Sess. 30-31 (1976).[21]

[21] Moreover, many of these tax incentives operate only to effect a deferral, rather than a permanent reduction, in taxes. For example, accelerated depreciation provides a special tax benefit only in the early years of a property's life; as the property ages, there arrives a crossover point at which accelerated depreciation begins to provide a smaller annual deduction than would have been available under straight-line depreciation (which is supposed to reflect the true economic depreciation). Thus, tax losses in early years may be counterbalanced by gains in later years, so that the total taxable income reported over time remains unaffected. In addition, some of the tax savings otherwise provided by such tax shelter items is currently subject to recapture through the minimum tax imposed by 26 U.S.C. 56 and 57. See Pet. Br. 43-44. In petitioner's case, however, the deductions that generate the tax losses it reports from its nonmember activity are not subject to recapture and do not merely reflect deferral of taxation. If petitioner continues to allocate a portion of its fixed expenses to nonmember sales as it has done in the

Thus, these examples are fully consistent with the decision of the court of appeals that "profit motive" must be determined by taking into account all of the economic costs associated with the activity--both fixed and variable. The losses reported on petitioner's tax return do not stem from tax preferences not designed to reflect net income; rather, they stem from standard "business expenses," such as payroll, cost of goods sold, insurance, and the like. See J.A. 52-59, 64-65, 69-72.[22] Since petitioner does not intend to receive gross income in excess of these basic economic costs of its nonmember sales, it does not conduct that activity with the kind of "profit motive" needed to allow deduction of business expenses.[23]

tax years at issue here, it likely will report losses from that nonmember activity forever. See J.A. 63.

[22] No commercial establishment would stay in business if it continued indefinitely to sustain losses of the magnitude claimed by petitioner year after year. The "economic gain" (*i.e.*, excess of gross receipts over variable costs) to which petitioner points would not be generated if an unsubsidized commercial establishment operated petitioner's nonmember activity. The apparent gain is achieved only by ignoring the fixed overhead, *i.e.*, by treating the commercial nonmember operation as being able to use the premises without paying any rent, insurance, etc. Clearly, it is not appropriate to calculate petitioner's tax liability on the assumption that nonexempt activity will be subsidized in this manner by the club, when the original impetus for the enactment of the unrelated business income tax was to prevent tax-exempt organizations from using their exemption to subsidize unrelated business activity. Thus, looking at the nonmember operation as if it were a private operation, it is apparent that it is not organized and operated in a way that it can make a profit.

[23] Petitioner also suggests (Br. 34-38) that the question of "profit motive" in this case is a factbound one, and that the

3. Petitioner's position with respect to the meaning of "profit motive" rests on an inherent contradiction, and should be rejected for that reason alone. Petitioner asserted on its tax returns that the allocated portion of its fixed expenses were "directly connected with" (I.R.C. § 512(a)(3)) the production of gross income from the nonmember sales. In petitioner's words, those were "the ordinary and necessary costs of generating" the income (Br. 33). When it comes to the profit motive inquiry, however, petitioner ignores those expenses—*i.e.*, it maintains that, despite the nonmember activity, the fixed expenses were sus-

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court of appeals impermissibly interfered with the Tax Court's discretion to consider the "facts and circumstances" of each case. This is mistaken. The extent to which a taxpayer operates an activity in a professional manner (see Pet. Br. 36-37) can be a relevant factor in a case where it is not otherwise apparent whether the activity was intended to produce a profit. But if it is apparent that the taxpayer does not intend to produce a profit, there is no "profit motive" regardless of how the operation was run. Here, there is no dispute over the material facts. Sales of food and drink to nonmembers were priced at a level "intended to result in profit to the club over the direct cost associated with the activity" (Pet. App. 20a-21a). On the other hand, when the *total* costs allocated to the activity are considered, petitioner reported a substantial loss every year totalling more than $400,000 over an 11-year period (J.A. 91), and there has never been any suggestion that petitioner intended to bring in gross receipts that would exceed these total costs. Thus, the Tax Court's conclusion that the profit motive standard was satisfied did not turn on any factual findings; rather, it turned entirely on the legal question of the correct definition of "profit" for these purposes. The Ninth Circuit correctly concluded that the Tax Court had evaluated uncontroverted facts according to an incorrect legal standard. See *North Ridge*, 877 F.2d at 755.

tained solely in connection with petitioner's recreational and member functions.[24]

Petitioner is simply trying to have it both ways—insisting that these fixed costs are actual expenses of its nonexempt activity when it wants to offset the gross receipts from that activity, and then in turn denying that these fixed costs are actual expenses when it wants to demonstrate that it intends the gross receipts from that activity to exceed expenses (a prerequisite to deducting the excess expenses against unrelated investment income). There is no reason to countenance this manipulation of the fixed expenses to generate either "profits" or "losses," at

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[24] There may be room to debate whether the fixed costs allocated by petitioner to its nonmember sales constitute true economic costs of that activity that ought to be treated as "directly connected" to the production of the nonmember sales income. It might be argued that only the variable costs are "directly connected with" the nonmember activity, and therefore that only those variable costs should offset the gross receipts from the nonmember income. Cf. *North Ridge*, 89 T.C. at 573 & n.18. That approach would tend to increase the tax on a social club's nonexempt income by reducing the costs that could be used to offset the nonmember receipts. Petitioner and other social clubs, however, have maintained that an allocable portion of the fixed costs should be treated as "directly connected" with the production of the nonmember income, and the Commissioner has acquiesced in that treatment. Not satisfied with eliminating all tax liability for its nonmember sales, petitioner now seeks to eliminate any tax liability for its unrelated investment income as well—by manipulating its characterization of the fixed expenses. But having identified these costs as "directly connected," *i.e.*, as genuine economic costs associated with the nonmember activity—a position that is critical to its deduction claim—petitioner should not be permitted to reverse its field and disregard these costs in determining the existence of a profit motive.

petitioner's whim; either the allocated fixed costs are directly connected, ordinary costs of generating the income from the nonmember activity or they are not. Indeed, petitioner's attempt to ignore the fixed expenses in the profit motive determination is particularly inappropriate in this context where those are the very expenses whose deductibility turns on the question of profit motivation. If the costs are connected with the nonmember activity for purposes of generating the reported net losses, they must also be connected with the activity for purposes of determining whether petitioner contemplated that the activity would produce profits or losses, which in turn determines whether the reported losses can be used to offset unrelated income.

Petitioner's interpretation of profit motive would essentially defeat the statutory purpose of taxing the investment income of social clubs. Every social club has fixed overhead, and many clubs provide food and drink or other goods or services to nonmembers—at prices that exceed variable costs but do not exceed the sum of the variable and fixed costs that can reasonably be allocated to such activity. If petitioner were correct that fixed costs may be used to generate tax losses and then ignored in determining profit motive, it would be easy for social clubs to use this kind of nonmember activity to convert their normal overhead, incurred for "pleasure, recreation, and other nonprofitable purposes" (I.R.C. § 501(c)(7)), into tax-deductible losses that would eliminate the tax on their investment income. See *North Ridge*, 877 F.2d at 756; *The Brook*, 799 F.2d at 840. This result would effectively insulate the investment income of most social clubs from taxation, thereby reinstating the very problem that Section 512(a)(3) was enacted to solve. See pp. 17-18, *supra*.[25]

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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[25] Petitioner suggests (Br. 47-48) that, even if the court of appeals' analysis of profit motive is correct, this Court should nonetheless reverse the judgment below because the Tax Court found that, if a different method were used to allocate fixed expenses, petitioner could show that the receipts from nonmember sales were intended to exceed the total costs of the activity. We submit that this argument is untenable basically for reasons discussed above (see pp. 44-46, *supra*); in using different methods of allocation for different purposes, petitioner would be asserting that the same fixed costs are connected to nonmember activity when it wants to generate tax losses and are connected to exempt activity when it wants to show the possibility of profit from the nonmember activity. In any event, it would clearly be inappropriate for this Court to rule for petitioner on this theory when the court of appeals declined to rule upon it; instead, the court below appears to have left it open to petitioner to make this argument in the Tax Court on remand. See note 7, *supra*.

APPENDIX

The Internal Revenue Code (26 U.S.C.), as in effect for the years 1980 and 1981, provides in pertinent part:

Sec. 511. Imposition of tax on unrelated business income of charitable, etc., organizations

(a) Charitable, etc., organizations taxable at corporation rates

(1) Imposition of tax

There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a tax computed as provided in section 11. In making such computation for purposes of this section the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income".

(2) Organizations subject to tax

(A) Organizations described in sections 401(a) and 501(c)

The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501(c)

(1) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a)

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Sec. 512. Unrelated business taxable income

(a) Definition

For purposes of this title—

(1) General rule

Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

* * * * *

(3) Special rules applicable to organizations described in section 501(c)(7) or (9)

(A) General rule.

In the case of an organization described in section 501(c)(7) or (9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraph (6), (10), (11), and (12) of subsection (b). For purposes of the preceding sentence the deductions provided by sections 243, 244, and 245 (relating to dividends received by corporations) shall be

treated as not directly connected with the production of gross income.

(B) Exempt function income

For purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside—

(i) for a purpose specified in section 170(c)(4), or

(ii) in the case of an organization described in section 501(c)(9), to provide for the payment of life, sick, accident, or other benefits,

including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii). If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than that described in clause (i) or (ii), such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

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